

CALIFORNIA LOTTERY

Audit Report

BUDGET PROCESS

July 1, 2009, through February 28, 2011



JOHN CHIANG
California State Controller

March 2012



JOHN CHIANG
California State Controller

March 30, 2012

California Lottery Commission
California Lottery
700 North Tenth Street
Sacramento, CA 95811

Dear Commissioners:

The State Controller's Office audited the California Lottery's (Lottery) budget process, for the period of July 1, 2009, through February 28, 2011.

Our audit disclosed the following deficiencies in the Lottery's administrative and internal control over Lottery's budget process:

- Methodology used in preparing budget for retailer compensation did not result in accurate estimation of retailer compensation;
- Proper approval on budget adjustment request was not evidenced;
- Sales revenues and prize expenses were not supported with adequate documents;
- Policies and procedures have not been updated or are not in existence; and
- Budgeted administrative spending reserve was not adequately supported.

If you have any questions, please call Andrew Finlayson, Chief, State Agency Audits Bureau, at (916) 324-6310.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/bf:wm

cc: Nathaniel Kirtman III, Commissioner, California Lottery Commission
John Smolin, Commissioner, California Lottery Commission
Phil Tagami, Commissioner, California Lottery Commission
Robert T. O'Neill, Director, California Lottery
Mike Ota, Deputy Director, Finance, California Lottery
Roberto Zavala, Chief Internal Auditor, California Lottery

Contents

Audit Report

Summary	1
Background.....	1
Objectives, Scope, and Methodology	2
Conclusion.....	3
Views of Responsible Official.....	3
Restricted Use	3
Findings and Recommendations.....	4
Attachment—California Lottery’s Response to Draft Report	

Audit Report

Summary

The State Controller's Office (SCO) audited the California Lottery's (Lottery) budget process for the period of July 1, 2009, through February 28, 2011.

Our audit disclosed the following deficiencies in the Lottery's administrative and internal control over the Lottery's budget process:

- Methodology used in preparing budget for retailer compensation did not result in accurate estimation of retailer compensation;
- Proper approval on budget adjustment request was not evidenced;
- Sales revenues and prize expenses were not supported with adequate documents;
- Policies and procedures have not been updated or are not in existence; and
- Budgeted administrative spending reserve was not adequately supported.

Background

By authority of the California Constitution, Government Code section 12410 states, "The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provision of law for payment." In addition, Government Code section 12411 stipulates that "... the Controller shall suggest plans for the improvement and management of revenues."

Proposition 37, the California State Lottery Act of 1984 (Lottery Act), amended the California Constitution to authorize the establishment of a statewide lottery, to create the California Lottery Commission, and to give the commission broad powers to oversee the operation of a statewide lottery.

Pursuant to Government Code section 8880.67, the SCO may conduct other special post-audits of the Lottery, as the State Controller deems necessary. The Controller or his/her agents conducting an audit under this chapter shall have access and authority to examine any and all records of the California Lottery Commission.

The Lottery Act created a special fund within the State Treasury known as the Lottery Fund. The State Lottery Fund operates as an enterprise fund and is required to be entirely self-funded from lottery sales. As a result of an amendment to the Lottery Act—Assembly Bill (AB) 142, effective April 8, 2010—the Lottery returns no less than 87% of the total annual revenues from the sales of Lottery tickets to the public in the form of prizes and net revenues to benefit public education. Therefore, the administrative cost cannot exceed 13% of the sales.

The Lottery's budget is largely dictated by the amount of sales that the lottery is expected to generate. As actual sales become known during the year, the Lottery makes any necessary adjustments in the approved budget to account for the difference between forecasted sales and actual sales.

Unlike most government-funded State agencies, the Lottery's annual budget is not subject to legislative review and approval through the State's budget process. The Lottery Commission is responsible for final approval of the Lottery's annual budget and business plan. For fiscal display and control purposes, the Lottery Commission's approved budgets are prepared by category of expenditure or budget line item.

Objectives, Scope, and Methodology

We conducted this performance audit in accordance with generally accepted government auditing standards. We did not audit the Lottery's financial statements. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The purpose of the audit was to determine if the Lottery is maintaining effective systems of administrative and internal accounting controls over the budget process.

The detailed objectives of the audit were to determine whether or not:

- The budget process provided sufficient controls to ensure that the Lottery's budget was developed and monitored in compliance with applicable act, regulations, management policies, and procedures.;
- Key controls over the budget process were adequate to ensure that the Lottery's annual budget was monitored periodically throughout the fiscal year; and
- The budget was used as an effective tool for guiding operations and evaluating organizational and divisional performance.

The procedures performed during the audit included:

- Reviewing the California Lottery Act, state laws and regulations, and any other applicable policies and procedures related to the budget process;
- Documenting a description of the internal controls over the budget process encompassing the Lottery's policies and procedures;
- Analyzing and evaluating the internal controls for the budget process by identifying the strengths and weaknesses; and
- Performing tests to determine if control objectives are being properly achieved.

Conclusion

Our audit of the Lottery's budget process disclosed that the Lottery lacks proper internal controls in the areas of budgeting retailer compensation, budget adjustment request approval, maintenance of supporting documentation, and written policies and procedures. The findings and recommendations section of this report summarizes the control deficiencies noted.

**Views of
Responsible
Official**

The SCO issued a draft to the Lottery dated November 29, 2011. Linh Nguyen, Acting Director, responded by the attached letter dated December 15, 2011. Mr. Nguyen agreed with Findings 2, 3, and 4, but disagreed with Finding 1 and the recommendation for Finding 5.

Restricted Use

This report is intended for the information and use of the California Lottery, the California Lottery Commission, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of the final report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

March 30, 2012

Findings and Recommendations

**FINDING 1—
Methodology used in
preparing budget for
retailer compensation
did not result in
accurate estimation of
retailer compensation.**

The methodology used by the Lottery in the budget preparation (Budget Office methodology) to calculate the retailer compensation is inaccurate. The Budget Office methodology to calculate the retailer compensation varies from the compensation methodology stated in the Lottery Regulations (regulations methodology). The two methodologies result in significant differences in calculating some of the retailer compensation amounts. The Budget Office methodology used in the budget preparation is a percentage of sales for all types of retailer commission (see column [2] of Table 1). The regulations methodology for some games is based on a percentage of prize expenses instead of sales (see column [3] of Table 1).

The deviation from the regulations may subject the Lottery to risk of inaccurate budgeting if the Budget Office methodology is not evaluated periodically for accuracy. In evaluating the accuracy of the Budget Office methodology, the auditor ran the actual sales data for fiscal year (FY) 2009-10 on the Budget Office methodology to calculate the budgeted retailer compensation, and compared the result with the actual payment of retailer compensation which was calculated based on the Lottery regulations. This comparison excluded the variance due to sales forecasting error. Columns [4], [5], and [6] on Table 1 (page 5) show the amounts calculated based on the Budget Office methodology in retailer special handling fees, retailer incentives, and retailer cashing bonuses are inaccurate by 3%, 30.8%, and 8.6%, respectively. In addition, this comparison of Budget Office methodology and regulations methodology based on actual sales, even though suggested by Lottery management to the auditor, was not performed by the Lottery to evaluate the accuracy of its methodology for FY 2009-10.

In addition, the budget assumption stated on the budget statements does not agree with the compensation agreement stated in the regulations regarding the retailer incentives. The assumption per the final budget stated that the retailer incentive is 0.2% of the top prize value; however, the regulations disclosed that the retailer incentive is 0.5% of the top prize value.

**Table 1—Comparison of Budget Office Methodology and Regulations
Methodology Based on Actual Sales Data for FY 2009-10**

[1] <i>Retailer Compensation Types</i>	[2] <i>Methodology Used in Budget Preparation (Budget Office) Methodology</i>	[3] <i>Compensation Methodology Stated in Regulations Methodology</i>	[4] <i>FY 2009-10 Compensation Based on Budget Office Methodology</i>	[5] <i>FY 2009-10 Compensation Based on Regulations Methodology</i>	[6] <i>Difference</i>
Retailer commissions	The projected retailer commission for Scratchers and Draw games was calculated on 5.95% of sales.	Retailers should be compensated based on 4.5% of sale for Draw games ticket issued from a self-service ticket dispensing machine; 6% of sales for Draw game tickets from a retailer clerk terminal; and 6% of sales for Scratchers tickets.	\$180,937,112	\$179,612,000	\$(1,325,112) -0.7%
Retailer special handling fees	The projected retailer special handling fees were calculated on 0.575% of sales for Scratchers and 0.655% of sales for Fantasy Five.	Special handling fees are \$0.06 for each replay ticket related to Draw game and 6% of retail sales prices for each replay ticket related to Scratchers game.	\$10,394,261	\$10,718,000	\$323,739 3%
Retailer incentive	The projected retailer incentives were calculated as 0.15% of sales for Scratchers and 0.2% of sales related to Draw games.	Retailer incentives are 0.5% of the top prize value.	\$2,998,038	\$4,331,620	\$1,333,582 30.8%
Retailer cashing bonus	The projected retailer cashing bonuses were calculated as 0.02% to 1% of sales.	Retailer cashing bonuses are 1% of the prize value paid on \$1 to \$599 tickets related to Scratchers, and 3% of the prize value paid to players for cashing Draw tickets with aggregate prize amounts from \$99 to \$599.	\$20,533,628	\$18,902,929	\$(1,630,699) -8.6%

Recommendation

The Lottery should:

- Periodically evaluate the accuracy of its current methodology to budget each component of retailer compensation. The Lottery should develop policies and procedures which ensure that the result from the Budget Office methodology is close to the result from the regulations methodology.
- Periodically compare the budget with actual costs by each component of retailer compensation instead of by aggregate amount.

Lottery's Response

The Lottery disagrees with the finding. Table 1 in the audit report is used to support this finding. It appears this table is intended to compare what the Lottery's budget for retailer compensation would be using our existing budget methodology against actual sales data for Fiscal Year 2009-10 with actual payment of retailer compensation during Fiscal Year 2009-10.

We have concerns with the numbers presented in Table 1. We disagree with the calculation of budgeted retailer compensation shown in Column [4] of the table. Column [5], the column for actual payment of retailer compensation, contains incorrect data. We are unable to determine the source of the numbers used in Table 1 of the audit report.

However, we performed the calculations described in the narrative of Finding 1 and concluded that the net difference between 1) the budget for retailer compensation using the Lottery's current methodology and 2) actual expenditures for retailer compensation is \$686,000 which represents a variance of three tenths of one percent (.003). Below is a table with our calculation:

(Dollars in Thousands)

	FY 2009-10 Compensation Based on Budget Office Methodology	Actual Payment per FY 2009-10 Financial Statements	Difference
Commission	\$180,937	\$179,612	\$1,325
Special Handling	10,498	\$10,718	(\$220)
Incentives	3,009	\$4,332	(\$1,323)
Cashing Bonus	20,726	\$19,822	\$904
Total	\$215,170	\$214,484	\$686
% of Difference		0.003%	

We feel the methodology used in preparing the budget for retailer compensation did result in accurate estimation of retailer compensation. That being said, our discussions with the auditors did identify areas where we should review our current methodology for budgeting retailer compensation and have included this as an action item for development of the Fiscal Year 2012-13 budget.

SCO's Comment

The Lottery based the evaluation on aggregate level, instead of by compensation type. The Lottery's budget includes four types of retailer compensations for FY 2009-10. Each of the retailer compensation types has different rates and amounts paid to retailers, and each of the retailer compensation types are budgeted individually. The Lottery's comparison at aggregate level disclosed a variance of 0.3%. However, the SCO-revised Table 1 in the final report discloses significant variances in the percentages of 3%, 30.8%, and 8.6% for retailer special handling fees, retailer incentives, and retailer cashing bonuses, respectively. Therefore, we believe that the retailer compensation should be evaluated periodically, by individual retailer compensation types instead of by aggregate level. The Lottery should adjust the percentage used for budget calculation to accurately budget each type of retail compensation.

In addition, we noted the following from the Lottery's response:

- The percentage of difference in the Lottery's table in response to Finding 1 is 0.003%. According to the data listed in the Lottery's table, the correct percentage of difference should be 0.3%.
- The Lottery included \$919,214 of actual retailer payments for Cash Box Compensation in the Cashing Bonus compensation type in the table included in the Lottery's response to Finding 1. The documentation provided to us by the Lottery included a zero budget balance for the Cash Box Compensation type for the final revised budget.

The Lottery's response also states, "We disagree with the calculation of budgeted retailer compensation shown in Column [4] of the table." During a meeting on December 15, 2011, requested by Lottery management, the Lottery did not dispute Column [4] FY 2009-10 Compensation Based on Budget Office Methodology and expressed that the SCO figures and Lottery figures were very close. The table below presents the SCO figures and Lottery figures in Column [4]. The table discloses that the variances are insignificant.

Column [4] Compensation Based on Budget Office Methodology				
	<i>SCO Figures</i>	<i>Lottery Figures</i>	<i>Variance in Dollars</i>	<i>Variance in Percentage</i>
Retailer commissions	\$ 180,937,112	\$ 180,937,000	\$ 112	0%
Retailer special handling fees	10,394,261	10,498,000	103,739	1%
Retailer incentive	2,998,038	3,009,000	10,962	0.3%
Retailer cashing bonus	20,533,628	20,726,000	192,372	0.9%

In response to the Lottery's comments, we updated Column [5] of Table 1 in the final report.

The Lottery questioned the source of the numbers used in Table 1 of the audit report. On April 21, 2011, June 16, 2011, and July 7, 2011, we met with the Chief of Lottery Finance and Administration and his staff to discuss the table. Table 1 of the audit report is based on the Lottery's budget office methodology, actual sales data, and actual payment of retailer compensation data, provided by the Lottery's Budget Office. Column [5] is based on the actual payment of retailer compensation and regulations methodology.

The finding and recommendation remain unchanged.

**FINDING 2—
Proper approval on
budget adjustment
requests incurred was
lacking.**

Our audit disclosed that the Lottery lacked proper approval of requestor, Division Director, Budget Officer, and Lottery Director, in processing a budget adjustment request. Once the annual budget was approved by the Lottery Commission, the budget related to the administrative support portion can be adjusted via a budget adjustment request for current conditions, workload change, or policy change without Commission approval. Our review of 13 budget adjustment requests disclosed that the following items lacked proper approval:

- In 2 out of 13 budget adjustment requests, evidence of the requestor's signature was not provided.
- In 3 out of 13 budget adjustment requests, evidence of the Division Director's approval was not provided.
- In 4 out of 13 budget adjustment requests, evidence of the Budget Officer's approval was not provided.
- In 2 out of 4 budget adjustment requests related to augmentation from the administrative spending reserve, evidence of the Director's approval was not provided. Throughout the year, Lottery management can request funding from the administrative reserve for items that were not budgeted for.

Accuracy of budget changes and properly authorized appropriations were not ensured when the budget adjustment requests were not properly approved. The auditor was informed by Budget Officer that the approval process for budget adjustment requests is being performed electronically for the FY 2011-12 budget and that the Lottery will establish the new procedures for budget adjustment request approval.

Section 0601.20 of the Lottery Administrative Manual states that the budget adjustment process is designed to utilize a single document to document the approvals for the change.

Recommendation

The Budget Office should establish procedures to ensure the Budget adjustment requests receive proper approval either manually or electronically. In addition, augmentation from the administrative spending reserve should be approved by the Lottery Director.

Lottery's Response

The Lottery concurs with this finding. The report recognizes that the Lottery implemented a new process for budget adjustments during the time audit field work was being conducted. This new process requires approval by the Division Director in order to electronically submit the budget adjustment request to the Budget Office. Procedures also specify that the Lottery Director approve all augmentations requiring the use of the Administrative Reserve.

SCO's Comment

The Lottery concurs with this finding and recommendation.

**FINDING 3—
Sales revenues and prize
expenses were not
supported with adequate
documents.**

The Lottery did not maintain adequate documentation to support the sources of information used to derive the sales revenues and some prize expenses presented in the FY 2010-11 final budget, as disclosed in the following instances:

- When the initial sales forecast for FY 2010-11 was prepared by the Forecasting Department, the original sales data that were used to prepare the workbook and a snapshot of the workbook were not retained to support the initial sales forecast.
- The initial sales forecast was modified via multiple informal executive meetings to arrive at the \$3.519 billion sales revenue projected on the final budget. However, there was no evidence of approvals of the modification to the initial sales forecast, such as meeting minutes or proper sign-off. Audit trail evidence to support the final sales revenue reported on the final budget was not retained.
- Supporting documents to justify the \$32 million in Scratchers low-tier unclaimed prizes, \$5 million in special prize account, and \$7 million in breakage were not available.

The sources used to derive the initial sales forecast supply the foundation and basis for preparing subsequent sales forecasts and provide evidence as to why a sales forecast may have been too high or too low. It is critical to retain the source documentation to justify the data reported on the budget statements, and to retain adequate audit trail documentation.

Government Code section 8880.41, Accountability; Books and Records, states:

The director shall make and keep books and records that accurately and fairly reflect each day's transactions, including, but not limited to, the distribution of tickets or shares to lottery game retailers, receipt of funds, prize claims, prize disbursements or prizes liable to be paid, expenses and other financial transactions of the lottery necessary so as to permit preparation of financial statements in conformity with generally accepted accounting principles and maintain daily accountability.

Recommendation

The Lottery should retain adequate documentation to support the sources used in preparing the sales revenues and prize expenses presented in the final budget. Any assumptions made in projecting the sales amount should be supported by documentation describing the basis upon which the assumptions are made.

Lottery's Response

The Lottery concurs with this finding. However, we point out that the process to develop sales goals and associated prize expenses is an iterative process involving the Deputy Directors of Sales and Marketing, Business Planning and Finance as well as the Director. That process includes evaluation of various elements of the upcoming fiscal year's Business Plan and the resultant impacts on sales goals. The timeline for sales goal development spans 3-4 months. By the time the sales goals are finalized for the budget, all parties are fully aware of the evolution of the numbers.

We acknowledge that not all of the supporting documentation for Fiscal Year 2009-10 sales goals was readily available at the time of the audit. That issue was rectified during development of the Fiscal Year 2011-12 budget. We are confident that we have a proper audit trail for documentation of the development of budgeted sales goals and prize expenses.

SCO's Comment

The Lottery concurs with this finding and recommendation.

**FINDING 4—
Policies and procedures
were not updated or
were not in place.**

Our audit disclosed that policies and procedures are neither updated nor in existence to guide the Budget Office in the development, preparation, adjustment, monitoring and approval of the budget.

- The Budget Analysts' Manual, which serves as the Budget Office's policies and procedures, were not updated for major changes in a timely manner. The latest Budget Analysts' Manual that was provided to the auditor was dated April 2008. The manual disclosed that the Budget Preparation Guidelines were prepared by the Budget Office and distributed to the divisions; however, the Budget Office has not used the Budget Preparation Guidelines for two years. Instead, a budget development kick-off meeting is held (annually) to educate the divisions on budget development process. In addition, the administrative cost percentage reduction from 16% to 13% required by AB 142 (section 8880.4 of the Lottery Act) has not been reflected in the manual even though AB 142 took effect in April 2010. Our audit also found that the manual stated that "Usage of administrative spending reserve is not allowed without Commission approval" while the FY 2010-11 administrative spending reserve in the amount of \$236,099 had been used as of March 16, 2011, without Commission approval. Lottery staff expressed that the manual was outdated and that the usage of administrative spending reserve, except high dollar marketing costs, did not require Commission approval under current practice.
- The Lottery did not have written policies and procedures on its administrative spending reserve. As the Lottery usually can move the funds in the reserve to any categories within administrative costs without going to the Commission for approval, the Lottery should establish standardized, detailed procedures to guide each division on using the administrative spending reserve. The lack of formal procedures can cause inconsistency in budgeting for administrative spending reserve. On July 6, 2011, the Lottery provided us with a draft copy of the methodology for budgeting and monitoring the administrative spending reserve. The methodology was provided after the end of fieldwork.
- The methodologies for preparing budgeted sales revenues and budgeted prize expenses were provided throughout the audit, but they were not formalized into standard procedures.

At the end of fieldwork, the auditor was provided with a project charter that addresses deficiencies in formalizing and standardizing procedures of the Finance Division which includes the Budget Office.

Establishing and maintaining written policies and procedures helps ensure that if a key staff member leaves the Lottery, existing staff or new staff will be able to process the budget without disruption. Internal controls are needed to ensure that established written policies and procedures are maintained to guide the Budget Office in developing and preparing the budget.

Government Codes section 13401 states, in part:

Each state agency must maintain effective systems of internal accounting and administrative control as an integral part of its management practices. 1. The systems of internal accounting and administrative control of each state agency shall be evaluated on an ongoing basis and, when detected, weaknesses must be promptly corrected.

Section 8880.4 of the Government Code states that no more than 13% of the total annual revenues shall be allocated for payment of expenses of the Lottery.

Recommendation

In order for the Lottery to increase budget control, the Budget Office should:

- Update the Budget Analysts' Manual in a timely manner when a significant change occurs.
- Develop formal written procedures which should include, but not be limited to, (1) how to establish the reserve, (2) the types of expenses allowed, and (3) how to use the reserve. In addition, a written cost-benefit analysis or equivalent should be prepared to justify expenses of large dollar amounts of the reserve.
- Formalize the methodologies used to prepare the amounts reported on the budget statements such as the sales revenues and prize expenses.

Lottery's Response

The Lottery concurs with this finding. The report recognizes the Lottery's Finance Division had a project underway to address deficiencies in procedure documentation during the time audit field work was conducted. Formal documentation of procedures for the Budget Process has been completed. These procedures provide specific and comprehensive processes for performing each step of Lottery's budget process. The procedures conform to standards established for formal documentation and are subject to regular review.

SCO's Comment

The Lottery concurs with this finding and recommendation.

**FINDING 5—
Budgeted administrative
spending reserve was not
supported.**

The budgeted Administrative Spending Reserve in the amount of \$2.302 million for FY 2010-11 was not supported by documented analysis, historical data, and management assumptions. The Reserve is funding set aside for protection from an unexpected sales shortfall. The amount of Administrative Spending Reserve was determined by reducing the budgeted administrative cost from 13% of sales revenues. The 13% of sales is the maximum administrative cost the Lottery can spend per AB 142 (section 8880.4 of the Lottery Act). The calculation used to arrive at the Reserve amount provides the Lottery the opportunity to spend every dollar up to the maximum 13% of sales on administrative costs while the Lottery Act requires that expenses under the 13% must be allocated to the benefit of public education. Throughout the year, the Reserve amount is adjusted based on the actual sales revenues and administrative costs incurred. The lack of documentation to support the basis for establishing the amount of the Reserve provides no assurance that the dollar level established is appropriate. The portion of the budgeted Reserve that did not have supporting documentation should be moved to the budget item for Contribution to Education.

Section 8880.4 of the Government Code states, in part:

No more than 13 percent of the total annual revenues shall be allocated for payment of expenses of the lottery. . . . To the extent that expenses of the lottery are less than 13 percent of the total annual revenues, any surplus funds also shall be allocated to the benefit of public education. . . .

Government Code section 8880.41, Accountability; Books and Records, states:

The director shall make and keep books and records that accurately and fairly reflect each day's transaction, including, but not limited to, the distribution of tickets or shares to lottery game retailers, receipt of funds, prize claims, prize disbursements or prizes liable to be paid, expenses and other financial transactions of the lottery necessary so as to permit preparation of financial statements in conformity with generally accepted accounting principles and maintain daily accountability.

Recommendation

The Lottery should ensure that the budgeted administrative spending reserve amount is justified by documented analysis, historical data, and management assumptions. Any budgeted administrative spending reserve that is not supported should be allocated to the budget item for Contribution to Education.

Lottery's Response

The Lottery disagrees with the recommendation associated with this finding.

The Lottery's budget is built with the goal of containing an Administrative Reserve to provide protection against a sales shortfall and unanticipated expenses. Budget planning begins by quantifying the

total amount available for administrative spending based on projected sales for the fiscal year and determining how best to allocate this funding to maximize contributions to public education. Throughout the budget development cycle the amount of the Administrative Reserve is constantly reevaluated.

The Administrative Reserve for Fiscal Year 2010-11 that is cited in this finding is \$2.302 million. This represents four tenths of one percent (.004) of the Lottery's total Administrative Expense budget of \$458 million for that fiscal year.

After Commission approval of the budget, discussions to increase or decrease the reserve fund are a collaborative effort among the Lottery Director and Lottery senior staff. All decisions to utilize the Administrative Reserve funds are approved by the Director. In those instances where the proposed use of the Administrative reserve has a significant impact on the Lottery's business strategies, the Lottery Commission is informed and in some cases, may be requested to provide approval.

The process for developing and managing the Administrative Reserve has been approved by the Commission. This process provides the Commission both a safeguard against fiscal uncertainties as well as flexibility to take advantage of sales growing opportunities that may emerge during the fiscal year. But as evidenced by the amount of the Fiscal Year 2010-11 Administrative Reserve (\$2.302 million), it is set at a very conservative level in relation to the entire Administrative Expense budget needed to achieve the sales goal of \$3.5 billion for that fiscal year.

It is also important to note that at the end of the fiscal year, all funding remaining in the Administrative Reserve is transferred in its entirety to public education. Our conclusion is the current process for budgeting and managing the Administrative Reserve provides the maximum benefit to public education.

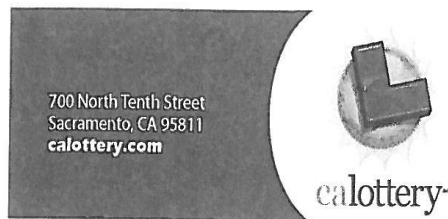
SCO's Comment

During the audit, the Lottery did not provide evidence that the Budgeted Administrative Spending Reserve amount for FY 2010-11 was supported by documented analysis, historical data, and management assumptions. Throughout the budget development cycle, when the administrative reserve is re-evaluated and changes are required, the Lottery should document justification for changes.

In its response, the Lottery states that all decisions to use the administrative reserve funds are approved by the Director. However, in Finding 2, we noted that two out of four budget adjustment requests relating to augmentation from the administrative spending reserve did not contain evidence of the Director's approval. In addition, we noted in Finding 4 that the FY 2010-11 administrative spending reserves, in the amount of \$236,000, were used on March 16, 2011, without Commission approval. The Budget Analysts' Manual states that, "Usage of administrative spending is not allowed without Commission approval."

The finding and recommendation remains unchanged.

**Attachment—
California Lottery's
Response to Draft Report**



December 15, 2011

Mr. Andrew Finlayson, Chief
Division of Audits
State Controller's Office
P.O. Box 942850
Sacramento, CA 94250-5874

Dear Mr. Finlayson

The California State Lottery (Lottery) offers the following comments and specific points regarding the recently concluded audit of the Lottery's Budget Process conducted by the State Controller's Office (SCO). As stated in the audit report dated November 29, 2011, the three objectives of the audit (for the period July 1, 2009 through February 28, 2011) were to determine:

1. The budget process provides sufficient controls to ensure that the Lottery's budget is developed and monitored in compliance with applicable act, regulations, management policies and procedures;
2. Key controls over the budget process are adequate to ensure that the Lottery's annual budget is monitored periodically throughout the fiscal year; and
3. Budget is used as an effective tool for guiding operations and evaluating organizational and divisional performance.

Thank you for the opportunity to respond to the audit report. We are pleased with the results of the audit. With respect to Objective 1, the audit identified opportunities to improve documentation of budget decisions and operating procedures but also acknowledged that the Lottery had already initiated efforts to address deficiencies in these areas. The improved documentation of budget decisions were implemented during development of the Lottery's Fiscal Year 2011-12 Budget and the updating of operating procedures has been completed.

The audit identified no findings regarding Objectives 2 and 3. The California State Lottery currently leads the nation's lotteries in terms of growth in sales. The ongoing management of the Lottery's budget to accomplish the sales goals is critical. The

preparation of a monthly "report card" of actual expenses compared to the annual budget is one element of the ongoing management of the Lottery's budget (Objective 2). Also, we have implemented improved processes and tools to evaluate organizational level budgets (Objective 3). We are pleased that the audit supports our efforts in these areas.

In summary, we found value in the results of the audit. With one exception, we agree with the recommendations in the report. Presented below are specific responses to each of the audit findings:

Finding 1

Methodology used in preparing budget for retailer compensation did not result in accurate estimation of retailer compensation.

Response:

The Lottery disagrees with the finding. Table 1 in the audit report is used to support this finding. It appears this table is intended to compare what the Lottery's budget for retailer compensation would be using our existing budget methodology against actual sales data for Fiscal Year 2009-10 with actual payment of retailer compensation during Fiscal Year 2009-10.

We have concerns with the numbers presented in Table 1. We disagree with the calculation of budgeted retailer compensation shown in Column [4] of the table. Column [5], the column for actual payment of retailer compensation, contains incorrect data. We are unable to determine the source of the numbers used in Table 1 of the audit report.

However, we performed the calculations described in the narrative of Finding 1 and concluded that the net difference between 1) the budget for retailer compensation using the Lottery's current methodology and 2) actual expenditures for retailer compensation is \$686,000 which represents a variance of three tenths of one percent (.003). Below is a table with our calculation:

(Dollars in Thousands)

	FY 2009–10 Compensation Based on Budget Office Methodology	Actual Payment per FY 2009–10 Financial Statements	Difference
Commission	\$180,937	\$179,612	\$1,325
Special Handling	\$10,498	\$10,718	(\$220)
Incentives	\$3,009	\$4,332	(\$1,323)
Cashing Bonus	\$20,726	\$19,822	\$904
Total	\$215,170	\$214,484	\$686
% of Difference		0.003%	

We feel the methodology used in preparing the budget for retailer compensation did result in an accurate estimation of retailer compensation. That being said, our discussions with the auditors did identify areas where we should review our current methodology for budgeting retailer compensation and have included this as an action item for development of the Fiscal Year 2012-13 budget.

Finding 2

Proper approval on budget adjustment requests incurred was lacking.

Response:

The Lottery concurs with this finding. The report recognizes that the Lottery implemented a new process for budget adjustments during the time audit field work was being conducted. This new process requires approval by the Division Director in order to electronically submit the budget adjustment request to the Budget Office. Procedures also specify that the Lottery Director approve all augmentations requiring the use of the Administrative Reserve.

Finding 3

Sales revenues and prize expenses were not supported with adequate documents.

Response:

The Lottery concurs with this finding. However, we point out that the process to develop sales goals and associated prize expenses is an iterative process involving the Deputy Directors of Sales and Marketing, Business Planning and Finance as well as the Director. That process includes evaluation of various elements of the upcoming fiscal year's Business Plan and the resultant impacts on sales goals. The timeline for sales goal development spans 3-4 months. By the time the sales goals

are finalized for the budget, all parties are fully aware of the evolution of the numbers.

We acknowledge that not all of the supporting documentation for Fiscal Year 2009-10 sales goals was readily available at the time of the audit. That issue was rectified during development of the Fiscal Year 2011-12 budget. We are confident that we have a proper audit trail for documentation of the development of budgeted sales goals and prize expenses.

Finding 4

Policies and procedures were not updated or were not in place.

Response

The Lottery concurs with this finding. The report recognizes the Lottery's Finance Division had a project underway to address deficiencies in procedure documentation during the time audit field work was conducted. Formal documentation of procedures for the Budget Process has been completed. These procedures provide specific and comprehensive processes for performing each step of Lottery's budget process. The procedures conform to standards established for formal documentation and are subject to regular review.

Finding 5

Budgeted administrative spending reserve was not supported.

Response:

The Lottery disagrees with the recommendation associated with this finding. The recommendation states:

"The Lottery should ensure that the budgeted administrative spending reserve amount is justified by documented analysis, historical data, and management assumptions. Any budgeted administrative spending reserve that is not supported should be allocated to the budget item for Contribution to Education."

The Lottery's budget is built with the goal of containing an Administrative Reserve to provide protection against a sales shortfall and unanticipated expenses. Budget planning begins by quantifying the total amount available for administrative spending based on projected sales for the fiscal year and determining how best to allocate this funding to maximize contributions to public education. Throughout the budget

development cycle the amount of the Administrative Reserve is constantly reevaluated.

The Administrative Reserve for Fiscal Year 2010-11 that is cited in this finding is \$2.302 million. This represents four tenths of one percent (.004) of the Lottery's total Administrative Expense budget of \$458 million for that fiscal year.

After Commission approval of the budget, discussions to increase or decrease the reserve fund are a collaborative effort among the Lottery Director and Lottery senior staff. All decisions to utilize the Administrative Reserve funds are approved by the Director. In those instances where the proposed use of the Administrative Reserve has a significant impact on the Lottery's business strategies, the Lottery Commission is informed and in some cases, may be requested to provide approval.

The process for developing and managing the Administrative Reserve has been approved by the Commission. This process provides the Commission both a safeguard against fiscal uncertainties as well as flexibility to take advantage of sales growing opportunities that may emerge during the fiscal year. But as evidenced by the amount of the Fiscal Year 2010-11 Administrative Reserve (\$2.302 million), it is set at a very conservative level in relation to the entire Administrative Expense budget needed to achieve the sales goal of \$3.5 billion for that fiscal year.

It is also important to note that at the end of the fiscal year, all funding remaining in the Administrative Reserve is transferred in its entirety to public education. Our conclusion is the current process for budgeting and managing the Administrative Reserve provides the maximum benefit to public education.

Sincerely,



Linh Nguyen
Acting Director

**State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, CA 94250-5874**

<http://www.sco.ca.gov>